

REAL ECONOMY: RADIOGRAPHY OF ECONOMIC YEAR 2010 IN MOLDOVA

SPECIAL ISSUE, No 16

JANUARY 2011

1. WHAT IS AN ECONOMIC RADIOGRAPHY?

Traditionally, at the beginning of every year, the independent think tank Expert-Grup makes brief reviews - radiographies - for the previous economic year. Like in 2008-2009, the radiography of the 2010 economic year will cover three essential aspects: a) the most important 5 economic events of 2010; b) the most revealing 5 macroeconomic trends; c) the most noticeable 5 faults of the economic policy. On the top of this we will add another interesting element: d) top 5 major risks for 2011.

We have to specify that these tops represent a joint vision of Expert-Grup team on the economic developments, but do not necessarily imply a strict ranking by their importance. In the annual economic radiographies we try rather to identify the events, statements and mega-trends that in our view were the key determinants for the previous economic year and will mark the medium and short term economic developments.

Before proceeding to these ratings, let's consider the difficult context generated by the 2009 financial crisis (Section 2) and how the Moldovan economy reacted in 2010 to the revitalization of the regional and global economic growth (Section 3).

2. BACKGROUND: THE 2009 ECONOMIC YEAR

In 2009 the global economy underwent the deepest depression in the post-war period, with a 0.6% decline in the global output. Among the biggest global actors, only a few emerging economies from South-East Asia (in particular,

This publication was supported financially by Soros Foundation Moldova as part of the project "Promoting Good Governance through Independent Economic Analysis and Forecast" The information and conclusions presented in this document belong exclusively to the authors and are not necessarily shared by Soros Foundation Moldova.

China and India) avoided the recession as such, but even their economic pace slowed down considerably.

All important trade and investment partners of Moldova were in a deep economic recession: with a -4.1% decline of the GDP for the Eurozone, -3.7% in East-Central Europe and -6.5% in the CIS. The Moldovan economy was contaminated through a decline in exports, direct foreign investments and, the most important, remittances sent by working Moldovan emigrants to their motherland.

3. RETROSPECTIVE OF THE 2010 ECONOMIC YEAR

In 2010 the monetary and fiscal incentives applied in many countries around the world contributed to the revival of the global economic growth. (However, identification of the optimal exit strategy without undermining the economic recovery and avoiding a new mega-crisis of the sovereign debts still remains a large problem). According to the IMF estimations, the global economic growth in 2010 accounted for about 4.8%. Similarly to the 2009 recession, it was very patchy in regional terms: in the Eurozone the GDP increased by about 1.7%, in East-Central Europe - by 3.6% and in the CIS - by 4.3%. Importantly, it is estimated that in 2010 the South-East Asia achieved a 9.4% increase, mainly on account of China. The "Top 5 Economic Trends in 2010" Section will show us why this observation is so important.

The revitalization of the economic growth on the global and regional arena in 2010 pulled the Republic of Moldova from the verge of economic abyss. The channels which allowed the financial crisis to enter the Moldovan economy in 2009 enabled the economic growth in 2010. The exports of Moldova increased by more than 20% till the end of the year. During the first three quarters the direct foreign investments increased by 50% and we expect quite the same growth to be reported for the entire year. The emigrants' remittances increased by almost 10% in the first three quarters. Their growth accelerated during the year and we think that the annual growth in 2010 amounted to about 12-13%.

Although the economic balance of 2010 is positive, it was marked by contradictory economic developments. On the one hand, the most important economic sectors resumed the positive economic growth (even though the Moldovan economy still needs another year for a complete recovery of the 2008 production level). On the other hand, this economic growth lacked any "human face" since it was merely a jobless economic recovery.

4. TOP 5 ECONOMIC EVENTS IN 2010

- ***On 29 January the IMF Executive Board approved the Economic Program with the Republic of Moldova amounting to USD 574 million.***
The resources were provided both to ensure external stability (for building up the NBM foreign currency reserves) and as a direct budgetary support, which gave the Government the so needed respite to put the public finance in order. At the same time, the IMF's approval of the Program inspired more confidence of other donors and investors as regards the economic course of the country.
- ***Consultative Group Meeting: Moldova Partnership Forum of 24 March.***
"Rethink Moldova" document, which stipulates the strategic reform priorities of the country, was presented at this meeting. The international donors pledged USD 2.6 billion as financial support for Moldova, half of which as grants, the rest - as concessional loans. Besides, the event served as an important stage in the diplomatic campaign aimed at improving the international image of Moldova.
- ***Floods Management.*** The floods in July 2010 had a limited geographical scale (mainly affecting the Hancesti and Cantemir districts), but the resources needed for the recovery of losses and provision of aid to victims were quite large, estimated at about USD 77.5 million (1.36% of the GDP estimated for 2010). But even more important, these floods revealed that the Republic of Moldova is not prepared fully to cope with disasters, even of a relatively small scale, let alone possible nationwide disasters. The physical infrastructure and technical means are in a precarious condition and by far do not correspond to the challenges posed by the climate change. The immediate warning capacities proved to be relatively good, but the institutional cooperation and post-crisis coordination were very poor.
- ***Approval by the Moldovan Government, on 14 December, of the RM Action Plan on the Implementation of the European Commission's Recommendations for the Establishment of a Deep and Comprehensive Free Trade Area between the Republic of Moldova and the European Union.*** This document contains a range of extremely important obligations, some of which are very difficult to implement without political, financial and technical support from the EU, which Moldova undertakes to implement during 2011-2015. Thus, 2015 may be viewed as a horizon, the Government and the EU consider more or less realistic, when the Deep and Comprehensive Free Trade Area could be established.

- ***Establishment of the Agriculture Payments and Interventions Agency and change of the subsidizing policy.*** Due to the lack of data, we cannot yet assess the systemic impact of these changes in the agriculture policy, but it is clear that these changes have narrowed considerably the loopholes used for corrupt arrangements and made the subsidizing policy fairer from the social viewpoint. However, considering the shortage of financial resources, it is extremely important to use them primarily to stimulate capital investments in agriculture.

5. TOP 5 ECONOMIC TRENDS IN 2010

- ***Surprisingly strong economic growth.*** According to the preliminary data, in the first nine months of 2010 the Moldovan economy grew by about 6.5% and our estimations for the entire year are at about 7%. This was determined by the revitalization of the consumption as an essential factor for the economic growth, growth of the agricultural output, re-launch of the services sector and stabilization of the constructions sector. The economic growth of Moldova in 2010 is likely to be among the highest growth rates in the Eastern and Central Europe and in the CIS.
- ***Further decline of employment.*** Despite the resumption of the economic growth, the employment rate achieved the lowest levels in 2010. According to our estimations, the annual unemployment rate averaged 47% (for the population of 15-59 years). Even before the crisis the employment rate in Moldova was very low - 50.8% in 2008. For comparison, the average employment rate in East-Central Europe in 2008 accounted for 65.6% and in the CIS - for 63.1%.
- ***China's advancement as trade partner of Moldova and the increase in the total trade deficit.*** According to the trade statistics for the first 11 months of 2010, currently China provides around 8.2% of the imports in Moldova, as compared to 7.5% in 2009. In 2010 China outstripped Germany, ranking the fourth in the list of Moldova's import partners. Considering the outstanding economic growth of China in 2010 (estimated at 10.5% by IMF) and forecasts for 2011 (9.6%), we should expect further augmentation of China's role in the Moldovan imports. We will not be surprised at all to see China ranking the third among the import partners of Moldova in 2011-2012. The major risk for Moldova is that its exports to China (USD 1.8 million) are negligible as compared to the imports (USD 281 million). Although the trade relations between Moldova and China are the most unbalanced as compared to any other country, Moldova has trade deficits with 102 of 117 countries it traded

with in 2010. The total trade deficit of Moldova increased by about 15% in 2010, exceeding, according to our estimations, USD 2.3 billion. Thus, the economy returns to the traditional high trade deficits (USD 3.3 billion in 2008, which in the context of the crisis decreased to USD 2.0 billion in 2009).

- ***Inflation recurrence.*** After a virtual lack of price increase during 2009, in 2010 the prices increased by an average of 7.3% and in December 2010, the price level was 8.1% higher than in December 2009. The price acceleration by the end of 2010 caused a moderate tightening of the monetary policy by the NBM, which on 30 December voted for the increase of the REPO rate from 7% to 8%. The efficient implementation of the inflation targeting policy is the main challenge the National Bank will have to deal with in 2010.
- ***Decrease of the bank interest rates and stabilization of the non-performing loans.*** According to our estimations, the interest rates for bank deposits in MDL in 2010 averaged at 9.3% (as compared to 14.7% in 2009) and for credits - at 17.2% (20.3% in 2009). In the context of a quite high inflation in 2010, this dynamic is very interesting, suggesting that either the banks anticipate quite moderate inflation in medium term, or that the competition for clients becomes tougher. In tandem with the decreasing interest rate, we found the stabilization, since April-May, of the share of non-performing loans in the total amount of bank credits. In 2009 we expected that their possible escalation could result in a systemic risk. The avoidance of a large-scale bank crisis is a doubtless achievement of the Moldovan Banks and NBM.

6. TOP 5 ECONOMIC GAFFES AND FAILURES IN 2010

- ***Failure to promote competition.*** Although the "elimination of monopolies" was one of the leitmotifs of the 2009 electoral campaign, in 2010 no perceptible progress was achieved in the area of competition protection, annihilation of the anti-competitive arrangements, and monopolies control. The studies conducted by European experts showed that in this area Moldova encounters systemic flaws; therefore, the approach to remedial actions should be systemic, not occasional.
- ***"Meat imports liberalization."*** High prices for foodstuff, particularly for meat, were another sensitive subject for voters in 2009. The Government's attempts to eliminate the monopoly schemes of meat import risked to end up as a farce, when at a certain moment the Government discussed the increase of the meat imports tariffs as a way

of protecting the local producers. These tariffs are already quite large, while prices paid by Moldovan consumers are among the highest in the region.

- ***The controversial declarations and decrees of the former acting president Mihai Ghimpu.*** The (un)diplomatic declarations and gestures of the former acting president produced neither more votes for the Liberal Party that Mr. Ghimpu leads, nor restoration of the historical truth he allegedly promoted. Instead, they annoyed the Russian Federation, which was not slow to find unwarranted chemical compounds in the Moldovan wines.
- ***Failure to publish the draft budget law for 2011 and failure to pass this law.*** Obviously, the country does not halt if the state budget law is not passed. The major problem is that the failure to publish the budget draft questions the compliance with the transparency principles and the failure to pass the law relates rather to political issues and considerations, than to some objective factors. This is a failure for a Government that committed itself to ensure transparency and observance of the law.
- ***Creation of the Balti Free Economic Zone.*** How can the creation of a Free Economic Zone be a failure? Quite easy, because the quick creation of this zone, alongside with the delay of some systemic reforms in the industrial policy (such as the establishment of Public-Private Partnerships, creation of industrial parks) shows that the Government prefers the path of least resistance in attracting foreign investments and encouraging the local ones. If German companies, with solid economic-financial positions, feel the need to become residents of free economic zones to be able to operate normally in Moldova, what can be said about Moldovan companies?

7. TOP 5 ECONOMIC RISKS FOR 2011

- ***Sclerotic economic growth.*** Against the Government's wishes to develop a economic growth model based on investments, innovations and exports, the Moldovan economy returns to the pre-crises consumption-driven growth model. This model will persist in 2011 and beyond, because it is not possible to change it in the short term. But there is the risk that half-hearted regulatory reforms will turn the current economic paradigm into a permanent phenomenon.
- ***Increase in the deficit of the State Social Insurance Budget.*** Related to the funding needs, the deficit increased from 14% in 2008 to 31% in 2010. Considering the demographic realities and the labor market, it is

difficult to believe in a recovery of the situation in 2011. From this viewpoint, the failure to pass the budget law for 2011 is a by no means a negligible risk.

- ***Uncertainties related to establishment of the Government Presidium.***
Looking for a mechanism of checks and balances, it seems that the parties from the AEI-2 have exaggerated. In our view, the establishment of a Council of the Alliance and ensuring permanent political dialog were sufficient to ensure a good coordination of policies and avoid tensions. The politicians' declarations on how the decisions will be passed in this Presidium are controversial, but exactly these disputes confirm the contradictory expectations the AEI-2 actors have regarding this structure. There is the risk that a coordination mechanism will become a mechanism for mutual immobilization and paralyzing, with negative consequences on the reform progresses.
- ***Price increase.*** We anticipate that during 2011 the consumption prices will increase by up to 6-7%, i.e. a little bit more than in 2010. However, the risks are high, because the consumption price indicator will depend very much on the monetary policy promoted by the National Bank, climate conditions and crop yield in 2011, as well as on the economic situation of the main trade partners of Moldova and the evolution of global commodities markets (particularly for cereals and oil). Over a few past months the global prices for food products surged. Considering the multitude of risks, it is important that besides a cautious monetary policy implemented by the NBM, the Government should adopt the structural and institutional policies that are vital for a good market competition.
- ***Aggravation of the sovereign debt crisis in the USA and Europe.***
Although Moldova is more exposed to the financial risks stemming from European markets, it is clear that a possible aggravation of the American debt crisis will blow the entire planet. By the end of 2011, the relative level of the US public debt will exceed the current level of Greece. Recently the US Treasury requested the American Legislature to increase the ceiling of the public indebtedness to avoid a default in 2011. Of course, not all European countries, neither the USA are as fragile as Greece, which lately had to be bailed out by the EU, but there are still considerable risks and uncertainties for investors, especially, considering that Ireland has already joined the PIGS countries and requested assistance. There are fears that Portugal, and then Spain could follow the same course. The latter is too big to fail, but also too big to be rescued.

8. THE MAIN CONCLUSION

Despite the revitalization of the economic growth in 2011, the Government should show more caution in respect to public expenditures and more courage in continuation of the key reforms. The philosophy underlying the change of the economic growth model should consists of the removal of the key constraints hindering the use of the country's resources (people and land) and giving priority to the financing of the infrastructure components that will have a multiplier impact on the economic growth.